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Discussant’s Response to
What Are the Courts Saying to Auditors?

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Mr. Sommer, in his excellent paper, clearly and forcefully tells us that the courts are saying to the auditors: “the ante has been raised in the auditing game.” Whatever else the cases he cites imply, they indicate business will be good for attorneys in the liability area throughout the 1970’s. In my opinion, these cases also will result, as with McKesson-Robbins, in an extension of auditing standards and an improvement in financial reporting.

Mr. Sommer summarizes the significant characteristics of the recent cases under three major headings.

1. The courts are making it much easier to sue the auditors.
2. The courts are asking auditors to establish generally accepted accounting principles; but where those principles are lacking, the courts are filling the voids.
3. The courts are holding the profession to its announced standards, but where the profession has been overly restrictive in defining such standards the courts are interpreting them quite broadly.

Let us consider these three characteristics concretely in terms of another case, that has yet to go to trial, that of National Student Marketing.

A civil action filed February 3, 1972 by the Securities and Exchange Commission against National Student Marketing Corporation, its auditors and two law firms in U.S. District Court (Washington, D.C.) asks for injunctive and other relief. At this early stage, all we have is a complaint. The actual facts, as substantiated by the evidence and decided on by the courts, may differ from the allegations. Nonetheless, the legal concepts and accounting issues are of such immediate significance that they are worthy of discussion at this time. Let us, therefore, review the allegations of the SEC, bearing in mind the possibility of revisions before final judgment is in.

The SEC charges the defendants with fraud and deceit. If the SEC prevails, this case will expand the potential liabilities of independent accountants under Rule 10b-5 of the 1934 Securities Exchange Act for audited financial statements.

It also will enlarge the responsibilities of auditors for comfort letters beyond those delineated in Statement on Auditing Procedure No. 48. Consistent with its contemporary activist policy, the SEC seeks injunctive relief not only against the registrant but also against others, including Peat, Marwick, Mitchell & Co.

Allegations by Securities and Exchange Commission

The complaint against the auditors contains basically two charges:
1) Deficiencies in the financial statements prepared between 1968 and 1970;
2) failure to report the contents of a 1969 comfort letter to the SEC.

The Story of National Student Marketing. National Student Marketing Corporation grew in two years from $723,000 of sales to $67.9 million. Cortes Randell, the founder and chief executive, captured the imagination of financial analysts and institutional investors with merchandising schemes ranging from computer-matched dating to half-fare cards for American Airlines. Wall Street wanted to believe in Cortes Randell, in view of the $45 billion annual disposable income of the youth market.

NSM was bought out at $6 in April 1968 and soared to a high of $144 by December 15, 1969—an increase of 2,300 per cent. The decline was equally dramatic. On February 1, 1972 NSM was selling at $9—an aggregate loss of over $450 million.

To what extent were these losses due to the cupidity of the investors? To what extent, if any, should the auditors absorb the losses? For an understanding of these questions, let us examine the SEC allegations in further detail.

Accounting for Unbilled Contracts. In the first place, the SEC asserts the 1968-69 financial statements were in error because contracts in progress were improperly recorded as receivables. For example, the SEC claims the balance sheet at August 31, 1968 overstated assets approximately $1.7 million by the improper recording of unbilled accounts receivable, and pre-tax earnings for 1968 were overstated approximately $696,000 out of a total of $699,000.

Subsequent to the issuance of the 1968 statements, management wrote-off unbilled accounts receivable of approximately $1,000,000. Cortes Randell stated the change was to put the company on a more conservative basis of accounting. However, the SEC claims that the write-off was in recognition of the fact that these unbilled receivables never existed or were otherwise uncollectible. Moreover, the SEC claims these changes were not adequately disclosed in the 1969 statements. The SEC also charges similar misstatements in the 1969 financial statements. We must await the answers of the defendants, and testimony of witnesses, to appraise the validity of these charges and to judge whether the financial statements were, in fact, erroneously prepared, or, simply were prepared according to the best evidence available at the time—later to be found wanting on the discovery of subsequent events.

Accounting for Sale of Subsidiaries. A second claim of the SEC concerns 1969 gains from the disposition of two wholly owned subsidiaries. It is claimed the sales not only were not at arm's-length, but also were initiated after 1969 and dated back to inflate the profits for that year. Moreover, Cortes Randell transferred some of his own NSMC stock to the purchasers, which they then used as collateral for the acquisitions. The SEC charges PMM failed to conduct its examination in accordance with generally accepted auditing standards once it knew of Randell's involvement in these transactions. As in Continental Vending, discussed by Mr. Sommer, we find auditing questions arising from the stock transactions of the holder of a controlling interest. Should the auditor expand the scope of his engagement when he discovers transactions that indicate a potential conflict of interest?

The Comfort Letter, the Auditor, and the Public. In addition to the fore-
going allegations relating to the audited financial statements, the SEC is also bringing charges regarding a comfort letter requested by counsel in connection with the merger of NSM and Interstate National Corporation on October 31, 1969.

As a result of facts discovered during its regular annual examination for the year ended August 31, 1969, the auditors could not render a clean letter. They proposed the amortization of $500,000 of deferred costs against the nine months ended May 31, 1969, and they suggested the write-off of receivables and recording of other charges totalling approximately $300,000. PMM recommended that NSM should consider submitting corrected data prior to proceeding with the closing. (This information was conveyed orally; the written letter was not delivered at this time.) Interim statements were not revised. Stockholders were not informed. Nevertheless, the merger took place.

The SEC charges the auditors failed in accordance with their professional obligation to insist that the NSMC financial statements be revised in accordance with the comfort letter, and failing that, to withdraw from the engagement. The SEC moreover, claims that the auditors had a duty to come forward and notify the SEC or the shareholders as to the materially misleading nature of the unaudited financial statements. Here, as in BarChris, discussed by Mr. Sommer, the SEC is attempting to expand the scope of the auditors' attest function in connection with comfort letters.

Relief Sought by the SEC. The SEC in this civil action is asking basically for two things:

1) a permanent injunction restraining defendants from future violations of federal securities laws; and
2) a mandatory injunction requiring NSM to revise the 10-Ks filed between 1968 and 1970.

Any other lawsuit—possibly a class action for money damages—would, of course, necessarily have to establish its case independently of the current one. However, it would seem the discovery of evidence for such an action would be facilitated somewhat by the present case.

What then Are the Courts Saying to Auditors?

This case reiterates three important issues for accountants outlined by Mr. Sommer in his thoughtful and well balanced paper:

1) The SEC is escalating its activist role. National Student Marketing is the first major case against accountants (and others) where a business failure has not taken place.
2) The SEC is raising once again a possible expansion of the overriding ethical concept of "fairness."
3) The SEC's actions, if sustained, will greatly expand the responsibility of the auditor for unaudited financial statements.

The Activist Role of the SEC. We have seen in BarChris, Yale Express, and Continental Vending a new activist role for the courts—emerging after some 35 years of experience with the federal securities laws. SEC v. NSMC signals another stage in that activist role. This is the first major civil case brought by the Commission against a registrant, its accountants, and attorneys for alleged de-
ficiencies in financial statements arising out of a situation other than a business failure. It no doubt will not be the last. At least, criminal action was not asserted, as in Continental Vending. But what is the next logical step in the SEC's policing of financial information under the federal securities laws? Will the SEC seek to audit the auditors?

In Yale Express, BarChris, Westec and Continental Vending, claims against the accountants arose in connection with business failure. In National Student Marketing, no such calamity triggered SEC action. Perhaps the next step would be for the SEC to evaluate the quality of auditing on all financials covered by the 1933 and 1934 Acts. Suppose the SEC, under its broad regulatory powers, would attempt to review auditors' working papers—at least on a sampling basis? In my opinion the added cost of such a review of auditors' working papers by the government would not be justified in terms of additional and more reliable financial information for investors. However, it seems clear that the already thorough and generally excellent intra-firm review function that exists in all major accounting firms must be greatly expanded in the light of the new activist role of the SEC. The reviewing partner will want to look beyond the audit program. He will want to ask himself at the end of every engagement: "Would I invest my money in this company?" If his question raises doubts, he should proceed on the assumption that he might be called into court to justify each financial statement item. The reviewing partner should also ask himself as an investor, "What additional information (by footnote or otherwise) would I like to have?" This means the courts are saying to the auditors: increase the scope of your engagements; increase your manpower; increase your fees.

The Primacy of Fairness Over Generally Accepted Accounting Principles.

Not only are courts saying to the auditors "expand the scope of your activities," they are also making promulgations about "fairness" in financial reporting, a concept which judges and lay juries are construing to take precedence over generally accepted accounting principles.

In Continental Vending, for example, Judge Friendly stated: "the critical test is not whether the statements were prepared in accordance with generally accepted accounting principles, but whether they fairly present financial information such that they contain no misstatements of fact, or, at least, no misstatements of facts known to the auditor." As Mr. Sommer comments in his paper: "the notion of the primacy of fairness over generally accepted accounting principles is less than unanimously acceptable to accountants." The concept of "fairness" is not operational. Fairness, like beauty, lies in the eyes of the beholder. To substitute it for generally accepted accounting principles would expose auditors to substantially greater hazards without proof that such a change would create a more liquid capital market.

The SEC is attempting to hold the defendants in NSM to the primacy of "fairness." The SEC charges PMM with misleading financial statements because:

1) the statements did not fairly present the facts; and additionally
2) the statements were not prepared in conformity with generally accepted accounting principles.

Why two separate complaints? Apparently, the SEC will try to establish both charges, but will be satisfied if it sustains one.
Action for Standard Beyond that Established by the Auditing Profession. Not only is the SEC apparently seeking to hold accountants for the primacy of fairness, but it also is attempting to require a standard of auditing beyond that required by the profession. At least, so it would appear from the comments of Victor M. Earle III, general counsel of PMM. The SEC charges the auditors should have insisted that NSM revise the financial statements in accordance with the comfort letter, and failing that should have withdrawn from the engagement and notified the SEC or the shareholders of the two companies. Victor Earle replied: “The plain implication of SAP 41 is that client confidences and state law and Rule 1.03 of the AICPA Code of Professional Ethics can be breached, if at all, only where the auditor has subsequently acquired information affecting his previously issued expression of opinion on audited financial statements.

“Here, the information acquired related to the company’s previously issued unaudited financial statements as to which the firm had not expressed an opinion.”

While SAP 41 applies only to events discovered by an auditor subsequent to the issuance of an opinion on audited financials, other statements on auditing procedure cover the responsibilities of the auditor to disclose facts he has discovered pertaining to unaudited statements that make such unaudited statements misleading, particularly in connection with a proxy or prospectus. For example SAP 47 (September 1971) at paragraph 23 states “. . . [If the auditor] concludes on the basis of facts known to him that the unaudited financial statements [in a registration statement] are not in conformity with generally accepted accounting principles he should insist on appropriate revision; failing that he should add a comment in his report calling attention to the departure; further, he should consider, probably with advice of legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement.”

SAP 47 states that an accountant should insist on “appropriate revision.” It does not specifically state that he should notify the SEC or stockholders. If the commissioner prevails in NSM, he will thus expand the responsibilities of the auditors. The courts are again urged to take auditing practice a step beyond that dictated by the standards currently pronounced by the members of the profession.

Concluding Remarks

It may be small comfort—but then at least some—for the accounting profession in the United States to note that they are not alone in their trial of fire. The UK cases of Candler v. Crane, Christmas & Co. and Hedley Byrne & Co.. Ltd. v. Heller and Partners, Ltd. were cited by Mr. Sommer.

In the December 1971 Abacus, W. P. Birkett and R. B. Walker describe major Australian company failures of the past two decades, including the Reid Murray group, and discuss the resulting lawsuits. They conclude “Perhaps more than any other factor, company failures have tested accountants’ claims to professional status, their capacity to respond to criticism, the quality of their organization and the rationale of their various practices.”

Nor have our Canadian neighbors been without their cases. In the May 1971 Canadian Chartered Accountant William A. Farlinger concludes in the Atlantic Acceptance Corporation case that although Atlantic’s failure resulted in
some large losses, those who suffered them were able to afford it. On the other hand, Atlantic has stimulated better financial information for investors.

What are the implications of these cases?
First, it seems highly probable that business for attorneys in the liability area will increase throughout the 1970's.
Second, some major auditing firms will suffer painful consequences, in the short run.
Third, the 1970's lawsuits—like McKesson-Robbins—will result in further extensions of auditing practices that will increase the prestige and importance of the auditing profession in the long run.

Footnotes